United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL 75-4124

United States Court of Appeals

For the Second Circuit

B
P/S

AARON KRAUT and IRIS KRAUT,
HARRY KRAUT and MARIAN KRAUT,

Petitioners-Appellants

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

BRIEF FOR APPELLANTS

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Preliminary Statement

The taxpayers appeal from adverse decisions of Judge Arnold Raum of the United States Tax Court. Judge Raum's opinion, filed June 27, 1974, will be reported, 62 T.C. No. 48. In his final decisions, entered February 21, 1975, he found these deficiencies in income taxes for the calendar year 1967:

Docket No.	*Petitioners*	*Amount*	
7663-70	Aaron and Iris Kraut	$240,787.08	(304)*
7664-70	Harry and Marian Kraut	$246,847.44	(306)

Judge Raum consolidated the cases for trial (19).

* References are to pages of the Joint Appendix.

This is a *Clay Brown-Berenson* case, after *Commissioner* v. *Clay B. Brown,* 380 U.S. 563 (1965), where the United States Supreme Court considered the tax consequences under section 1222 (3) of the Internal Revenue Code of 1954 of a sale of stock by an ordinary seller to a tax-exempt purchaser, and *Berenson* v. *Commissioner,* 507 F. 2d 263 (2d Cir. 1974), where the Second Circuit applied *Clay Brown.* The Supreme Court held that the proceeds of the sale were taxable as capital gains. The instant case arises from such a transaction entered into after the decision in *Clay Brown* and before the enactment of the Tax Reform Act of 1969.

Statutory Provision Involved

Section 1222 (3) of the Internal Revenue Code of 1954

(3) **Long-term capital gain.** The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent that such gain is taken into account in computing gross income.

Issues Presented for Review

(1) Is this a *Clay Brown-Berenson* case?

(2) Was Judge Raum correct in determining that any portion of the purchase price was "in excess of the price a nonexempt purchaser would have paid"? *Berenson* v. *Commissioner,* 507 F. 2d 263, 269 (2d Cir. 1974).

(3) If so, was his determination as to the amount of the excess correct?

Statement of the Case

On Judge Raum's own findings of fact, the issues presented for review must be resolved in favor of the taxpayers.

The taxpayers Iris and Marian Kraut, who owned all of the stock of Nassau Plastics and Wire Corp (Nassau Corp), had first contracted to sell their stock to Wilson Mold and Die Corp (Wilson Corp). Nassau Corp and Wilson Corp did not go through with the sale. Subsequently, in a separate three-cornered agreement, Wilson Corp assigned all of its rights and delegated all of its duties to the Cathedral of Tomorrow, Inc. (Cathedral) (280). The Cathedral was an exempt organization; Wilson Corp was not.

The purchase price was not less than $500,000 nor more than $3,500,000 payable out of 75% of Nassau Corp's net income before federal income taxes (280, 166, Ex. 4-D; 195, Ex. 5-E). The assignment from Wilson Corp to the Cathedral resulted from a detailed presentation that Eugene O. Cobert of Management Methods, Inc. made to the Cathedral (121, 199). The Cathedral, after a thorough investigation of Nassau Corp, bought the stock for the same price that Wilson Corp had agreed to pay.

Nassau Corp was a new corporation, organized in July, 1965 to develop and manufacture a new product, namely, copper wiring coated with a unique softer plastic insulation to be used in the Christmas tree lighting business (56, 58, 69, 161, Ex. 3-C).

The operations of Nassau Corp were experimental in 1965 but based on the trade's acceptance of its experi-

mental product as evidenced by its year end order backlog, in 1966 the sales of the new product skyrocketed, for the new product was a dramatically exciting type of Christmas tree lighting wire (69-70). The new softer coated wire had a spectacular market acceptance because it enabled Christmas tree lighting manufacturers to assemble their product with great accuracy and tremendous speed, with a minimal rejection rate, as Judge Raum found (277).

In 1967, pursuant to the agreement between the Cathedral and the shareholders of Nassau Corp, the Cathedral paid to the shareholders the amount of $1,268,275. Each of the shareholders after deducting expenses, reported on her 1967 United States income tax return the receipt of the net amount of $606,416.47 as a long-term capital gain pursuant to section 1222 (3) of the Internal Revenue Code of 1954, less those amounts reported as interest income in accordance with section 482 of the Internal Revenue Code of 1954 (138).

The Commissioner in one of the first applications of his new Rev. Ruling 66-153, 1966-1 C.B. 187, by which he sought to limit *Clay Brown,* in his statutory notices in this case acknowledged the validity of the sale by the shareholders of Nassau Corp to the Cathedral but sought arbitrarily and erroneously to value the stock of Nassau Corp at $168,445.60 (31), which was apparently some multiple of earnings of its development year. The figure that the principals themselves arrived at after hard bargaining at arm's length was $3½-million. On the basis of a multiple of projected earnings the figure could have been as high as $10-million. Judge Raum, however, accepted the Commissioner's figure of $168,445.60 (286).

Subsequently the Commissioner tried to get away from his statutory notices, which acknowledged the sale and allocated values, and argue in the alternative that perhaps there was no sale at all in the instant case. He did this by motions made both during and after trial. There was no basis for these motions, for the Commissioner put in not a shred of evidence to support them; and Judge Raum summarily denied them (2, 7). As the court held in *Wilson* v. *Commissioner,* 25 T.C. 1058, 1066 (1956):

> "While a statutory notice of deficiency is presumed correct, and a petitioner has the burden of disproving its correctness, when the Commissioner departs from the grounds relied on in his deficiency notice to sustain a theory later raised, he has the burden of proving any new matter raised."

Accord, McSpadden v. *Commissioner,* 50 T.C. 478 (1968); *Sheldon Tauber* v. *Commissioner,* 24 T.C. 179 (1955).

Under *Clay Brown-Berenson,* Judge Raum's own findings of fact invalidate his conclusions. Judge Raum made these findings of fact:

> "Petitioners Iris Kraut and her husband Aaron Kraut resided in Oceanside, New York, at the time they filed their petition herein; petitioners Marian Kraut and her husband Harry Kraut resided in Flushing, New York, at the time they filed their petition herein. Both pairs of petitioners timely filed joint Federal income tax returns for the year 1967 with the district director of internal revenue at Brooklyn, New York.
>
> "Aaron Kraut and his brother Harry together were in the business of developing and manufacturing electric wire of various types. For at least 20 years

they had owned and acted as president and vice president, respectively, of Trio Wire & Cable Corporation ('Trio'), which was primarily concerned with the production of assorted types of wires and cables encased in plastic insulation. In addition to and as an offshoot of that business the Kraut brothers in or around 1960 formed a separate corporation, Christmas Wire Manufacturing Corporation ('Christmas Wire'), through which they hoped to penetrate the more specialized and very competitive market for wiring used in the manufacture of Christmas decorations. Although Trio itself did not produce such wire, it owned the necessary machine, an extruder, which Christmas wire made use of. The extruder was housed in a leased building, one of three separate but interconnected buildings on Meserole Avenue in Brooklyn in which Trio carried on its business. That machine appears to have been the only item of equipment used in the production of the Christmas wire, and the record fails to show that any appreciable number of employees was engaged in its operation.

"The heart of the manufacturing process for Christmas wire consisted of extruding a coat of plastic insulation around light gage wire. The Christmas decoration manufacturers who purchased the wire then attached light bulb sockets to it by means of small brass spurs on the sockets which punctured the plastic jacket and made contact with the electric wire inside. A major problem for manufacturers of such wire was the normally tough consistency of the plastic used which created difficulty in attaching the sockets and thus led to a high 'rejection rate' in the decoration assembly process. As a result of various problems, primarily the rejection rate, the Kraut brothers brought production under Christmas Wire's name to an end sometime in the spring of 1965. Although the Krauts 'sold' the Christmas Wire corporation at that

time at a price not satisfactorily shown in the record, the purchaser never conducted operations at the Meserole Avenue location. The Krauts retained the use of Christmas Wire's premises as well as Trio's extruder which remained there. Within a very short time thereafter, possibly as little as several weeks and certainly no more than a few months, Harry and Aaron Kraut formed another corporation, Nassau Plastic & Wire Corporation ('Nassau'), which they intended would operate as an adjunct to Trio similar in fashion to Christmas Wire. As a matter of convenience, Nassau issued all of its stock, 200 shares, in equal amounts to Iris and Marian Kraut in return for their contributions to its capital of $100 apiece. Although neither Aaron nor Harry contributed to Nassau's capital, they nonetheless were the dominant figures in its activities, while their wives provided no services at all to it. Nassau occupied the same premises which Christmas Wire had previously used, and its only equipment was the extruder belonging to Trio which Trio had in the past supplied to Christmas Wire. Nassau required the extruder to manufacture Christmas wire with a new insulating material which, due to its easily penetrable consistency, promised to minimize the rejection problem associated with conventional plastic insulation. This new material was, however, 'an unknown quantity,' and its resistance to wear and decay over a period of several years was as yet unproven. Despite the new material's alleged superiority to the insulating material commonly in use at the time, the Krauts did not obtain, nor apparently did they apply for, a patent on it.

"On its Federal income tax return for the fiscal year ended June 30, 1966, Nassau reported gross income of $26,189.84, which represented the difference between its sales of $492,305.16 and its cost of goods sold, $466,115.32. The cost of goods sold consisted en-

tirely of merchandise bought for manufacture or sale; Nassau reported no expense for salaries and wages other than $2,600 paid to the Krauts, no expense for use of the extruder, nor any expense for the building in which it was kept. As of June 30, 1966, Nassau maintained no inventory whatsoever. After deducting the Krauts' salaries, taxes, depreciation on a car, and $5,913.40 of operating expenses, Nassau reported a taxable income of $15,831.56 and a resultant tax liability of $3,482.94.

"At some time in the early part of 1966, Management Methods, an investment counseling and legal firm located in New York City, brought to Reverend Rex T. Humbard, its client, a proposal for the purchase of Nassau. Reverend Humbard was the pastor of the Cathedral of Tomorrow ('Cathedral'), a Federally tax-exempt religious organization in Akron, Ohio. Its activities included conducting Sunday services, a Sunday school, and youth groups as well as sponsoring the worldwide telecast of its church services and supporting an extensive missionary program. Among its assets, Cathedral owned two businesses, at least one of which it had acquired in an entirely debt-financed transaction. After expressing his preliminary interest in the proposal concerning Nassau, Reverend Humbard with his associates undertook to examine Nassau's business more closely.

"Before the parties had entered a binding agreement, however, Iris and Marian Kraut executed an agreement with a party identified only as Wilson Mold & Die Corporation ('Wilson') on May 31, 1966, purporting to sell to it their entire interest in Nassau, payments to commence on September 1, 1966. Beyond its participation in this contract, the record contains no evidence as to any and all particulars in respect of Wilson and its principals.

"On the following day, June 1, 1966, Trio and Nassau executed an agreement whereby Trio leased to Nassau the extruder which Nassau had theretofore been using along with its accompanying apparatus. The lease was to run for a term of five years, to continue indefinitely thereafter but subject to termination by either party upon 60 days' written notice. Nassau agreed to pay Trio $500 per month. The lease further provided that:

"The Lessor [Trio] shall at all times have free access to the machines for the purpose of inspection or observation, or to make alterations, repairs, improvements, or additions, or to determine the nature or extent of use of the machines.

"Furthermore:

"The machines shall be used only by operators in the direct employ of the Lessee [Nassau], and only in the factory now occupied by it at its principal place of business, and shall be used only for the purpose of insulating and spooling copper wire, made by or for the Lessee.

"Iris and Marian Kraut signed on behalf of Nassau.

"Shortly thereafter, before the time of its performance had arrived, Nassau and Wilson abandoned their purported contract of sale. In a separate three-cornered agreement dated June 15, 1966, only 15 days after the initial contract, Wilson assigned all of its rights and delegated all of its duties arising under the May 31, 1966, agreement to Cathedral; Iris and Marian Kraut agreed to release Wilson from the prior contract; and Cathedral covenanted to purchase Nassau's stock according to the following terms:

"The Buyer [Cathedral] shall take all such action as may be required so that on or as of June 25,

1966 Nassau Plastic shall be liquidated and all of its assets distributed to the Buyer. Simultaneously with the execution of this Agreement, the Buyer, with the consent of the stockholders and directors of the Sellers [Iris and Marian Kraut], shall take steps forthwith to accomplish the following:

"(a) Create a separate operating-manufacturing unit, owned by the Buyer, to be denominated and known as Nassau Plastic (hereinafter sometimes interchangeably referred to as 'Nassau Plastic & Wire Co.' * * *); the Buyer to file such documents with the proper governmental authorities as may be necessary to effectuate the same.

"(b) The name of Nassau Plastic & Wire Corp. shall be changed forthwith, to such name as the Buyer may designate.

* * *

"The purchase price for all of the stock sold under this Agreement shall be not less than $500,000 (hereinafter called the 'Minimum Price') nor more than $3½ million (hereinafter called the 'Maximum Price'). The purchase price shall be paid by the Purchaser to the Sellers at the following time in the following manner and to the extent set forth below:

"(a) For the period from June 25, 1966 to July 1, 1966, 100% of the net income of the Corporation shall belong to the Sellers; the Purchasers shall receive credit for said amount toward the purchase price.

"(b) $50,000 on or before August 1, 1966.

"(c) For the balance of the year 1966 and in each of the years 1967 through 1976 terminating however on June 30, 1976 inclusive, unless the Maximum Price be paid in full prior thereto;

commencing with the 15th day of October 1966 and on the 15th day of each January, April, July and October thereafter in respect to each preceding quarterly period from July 1, 1966 through June 30, 1976, an amount equal to 75% of the Corporations [sic] net income before Federal income taxes for each of such next preceding fiscal periods. In the event a loss occurs in any quarterly period, said loss shall be utilized as an offset in each of the succeeding quarterly periods (until said loss has been recouped) before payments to the Sellers are resumed.

"(d) In any event and notwithstanding any provision in this Agreement with respect to the contingent deferral of installment payments of the Purchase Price, the full Minimum Price referred to above and any portion of the Maximum Price referred to above which Sellers may become entitled to receive shall be paid in full on or before July 15, 1976.

"(e) The Purchaser may prepay at any time all or any part of the unpaid amount of the Maximum Price.

"The terms of payment agreed to by Cathedral largely reflected the substance of Wilson's antecedent commitment, the one notable difference being that Wilson had agreed to pay 75 percent of its pre-tax earnings only through June 30, 1971, thereafter applying the same percentage to its after-tax income for the duration of the ten-year period.

"The ultimate transaction did not contemplate any cash outlay by Cathedral, either at the outset or in the event of default. Although the terms of the contract provided for an initial $50,000 payment on August 1 irrespective of Nassau's profits, Nassau's assets at the

time of the purported sale included $50,089.75 of notes and accounts receivable plus $2,323.36 in cash. In point of fact, petitioners permitted Cathedral to postpone that payment until mid-October, 1966, by which time Nassau had generated sufficient cash flow from which Cathedral could pay petitioners. Even though Iris and Marian Kraut retained a security interest in all of the assets, business, and good will of Nassau, their interest was subject not only to prior liens, but to 'the rights of present and future general creditors for obligations arising in the regular course of business, and liens, collateral or security for the loan or loans advanced or to be advanced by any bank.' Moreover, it was stipulated that, in the event of Cathedral's default in payments or otherwise, enforcement of the security agreement would constitute the seller's exclusive remedy 'and in no event shall the Sellers seek any deficiency judgment or other judgment for damages against the Buyer.' In addition thereto, Cathedral agreed to employ both Harry and Aaron Kraut as its chief executive officers, Aaron in the capacity of production manager and internal office manager and Harry as sales manager. As such, Cathedral granted them full authority and responsibility to direct the business of Nassau in every respect. For such services, Cathedral agreed to pay them each $5,200 yearly, their employment to terminate on the day following the date of Cathedral's final payment to Iris and Marian.

"At the time of this agreement, Nassau owned neither the building in which it operated nor the single piece of machinery with which it produced wire. Its interest in the machine consisted of the five year lease from Trio described above. On its tax returns for the year ending June 30, 1966, it listed total assets in the amount of $53,867.56, of which notes and accounts receivable amounted to $50,089.75; the remaining assets

consisted of cash and an automobile. In the same return, it reported $36,575.99 in accounts payable while its capital account showed $200 in respect of its common stock.

"Following the disposition of the stock, Nassau's operations continued at the same location wtih the same personnel using the same equipment, and apparently under the same or a very similar name. Harry and Aaron Kraut, as 'Cathedral's employees,' still managed the business. Under this arrangement the business met with early and quite remarkable success. Although on August 1 the business' cash flow apparently had been insufficient to provide Cathedral with the funds necessary to make the down payment then due, on October 12 Harry Kraut drew two checks of $25,000 each on Nassau's account in favor of Cathedral which Reverend Humbard then endorsed as payable to Iris and Marian Kraut individually. During the remainder of 1966 Cathedral paid Iris and Marian an additional $97,500; in 1967 Cathedral paid them a total of $1,332,500,[1] which raised the overall level of payments to $1,480,000. After 1967, though, the business rapidly became unprofitable, and in 1969 it ceased operating altogether. The sudden turnabout in the business' fortunes was attributable, at least in part, to its competitors' ability to reduce the rejection rate of their Christmas wire through improved techniques and production quality. Ownership of Nassau's then remaining assets, which were of negligible value, reverted to the original owners.

"In each of their respective joint income tax returns for 1967, petitioners reported the receipt of $666,-250 from Cathedral, of which they treated $27,720.83 as interest and from which the deducted collection ex-

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1. This is a gross amount against which there should be charged $64,225, the related expenses of collection, leaving a net amount of $1,268,275.

penses of $32,112.50, primarily brokers' commissions. They then listed the net amount of $606,416.67 in each return as long-term capital gains and computed their tax liability according to the alternative tax provided in section 1201(b). In each of his deficiency notices, the Commissioner determined

> "that $595,776.09 of the amount collected in 1967 pursuant to the sale of your shares of stock in Nassau Plastics & Wire Corp. to the Cathedral of Tomorrow, Inc. in 1966, payments to be made out of the profits of the company sold, constitutes ordinary income to you in 1967. * * *

"In arriving at this amount, the Commissioner assigned to the stock of Nassau a selling price of $168,-445.60, a value equal to ten times the taxable income of Nassau for the taxable year ended June 30, 1966.[2] He then made the following computation:

"Amount received in 1966 and 1967	$1,480,000.00
Less interest as reported	56,904.16
	$1,423,095.84
Amount deemed applicable to selling price of shares	168,445.60
Balance	$1,254,650.24
Less expenses incurred in 1967	63,098.07
Increase in ordinary income for 1967	$1,191,552.17
50% applicable to each shareholder	$ 595,776.09

2. Nassau's Federal income tax return for the year ended June 30, 1966, indicated taxable income of $15,831.56, which, multiplied by 10, equals only $158,315.60. The Commissioner, on brief, noted the discrepancy between this amount and the figure used in computing the deficiencies, but he does not now contend that the value of Nassau's stock should be limited to the lower figure" (274-86).

The taxpayers contend that not only was Judge Raum's determination that a portion of the purchase price was in excess of fair market value at complete variance with the subsequently decided case of *Berenson* v. *Commissioner,* 507 F. 2d 263 (2d Cir. 1974), but also based on his own findings of fact as well as the record he could have made no determination of any excess at all.

Because of the tremendous amount of orders that Nassau Corp had for its Christmas wire in 1966, it projected earnings over a ten-year period of at least $10-million and regarded this projection as a conservative one (85). Aaron Kraut testified:

> "A. I projected earnings in the area—and this is conservative, over a ten-year period of at least $10,000,000.00.
>
> "Q. If it could produce $10,000,000.00 in earnings over a ten-year period, well, how come you sold it for $3,500,000.00?
> "A. Because those were projections, and no one knows what is going to happen six months from now—
>
> "Q. The Cathedral offered you $3,500,000.00 for this business and you sold it immediately?
> "A. No.
>
> "Q. Tell me what happened?
> "A. We wanted $5,000,000.00 for it.
>
> "Q. Based on what?
> "A. On my projected earnings.
>
> "Q. And, why did you accept $3,500,000.00?
> "A. Well, it was a matter of bargaining, they didn't want to pay $5,000,000.00, and I didn't want $2,500,000.00 or whatever they come in, I think it was $2,500,000.00" (85-86).

Had Mr. Kraut's figure of earnings of $1-million a year been for past rather than projected earnings, a fair price for the stock of Nassau Corp would have been $10,000,000.00 or more.

Nassau Corp's earnings over a 3-year period from July 1, 1965 through June 30, 1968 were more than $2-million (Exs. 1-A, 2-B). Thus, Nassau Corp's average yearly net profit was $666,000. Valuing the business at a multiple of 5 or 6 and not 10, would produce a value of at least $3,500,000.

Mr. Kraut further testified that Nassau Corp's extruder was capable of producing anywhere from $2-million to $6-million of wire in each year of operation (85), resulting in approximately 15% to 20% of net profit. At that rate of generating profits, the Cathedral could pay out the petitioners in full in approximately 4½ years in accordance with the terms of the agreement of sale (195, Ex. 5-E).

In 1966 and 1967 the Cathedral paid the shareholders of Nassau Corp the sum of $1,480,750 (137-39, 149, Exs. 1-A, 2-B). This represented but 75% of the net income before Federal income taxes. At this rate the Cathedral would have paid out the shareholders of Nassau Corp in another two years in accordance with the terms of the agreement of sale.

The sale of Nassau Corp's stock to the Cathedral for $3½-million was the result of hard bargaining at arm's length. The price of $3½-million was based upon the amount of business in the house and the projections of sales and profits to be generated in the future. The Rev.

Humbard and his board of trustees approved the sale price of $3½-million after an independent investigation of the Nassau Corp, its plant and its product. The Rev. Humbard was intrigued by the "very unusual procedure" that Nassau Corp used to produce its Christmas tree lighting wire (128). He and his board of trustees were convinced that the purchase of the stock of Nassau Corp was in the best interest of the Cathedral.

Rather than challenge the sale price of 3½-million as being excessive, one can with equal and more reason challenge it as being too low. In 1966 the business community was paying ten times projected pre-tax earnings and more for the stock of a corporation which had a new product with the growth potential of the Christmas wire of Nassau Corp. One can argue that the stock of Nassau Corp should have sold for something like $10-million, rather than $3½-million.

Where then did the able and Honorable Judge Raum go wrong? We submit that he erred at several critical points. Judge Raum, one of the ablest judges of the United States Tax Court, who has sat there for decades, nevertheless was not sufficiently apprised of business methods and practices.

Judge Raum, having accepted the Commissioner's determination in his statutory notice that the instant case involved the sale of a capital asset, erred in his decisions as to what portion of the purchase price was to be accorded capital gains treatment. Here he merely accepted the government's erroneous and arbitrary determination of $168,455.60 (apparently some multiple of the development

year's earnings) without a single shred of evidence having been offered by the government, and in the face of substantial evidence by the taxpayers to the contrary.

The taxpayers suggest that a reading of Judge Raum's opinion will show that the thing which troubled Judge Raum the most would not have troubled an experienced business man at all. What troubled Judge Raum the most was the fact that Nassau Corp's book value was $12,548.62 as against a flexible sales figure between $500,000 and $3,500,000 (291). On further reflection he should not have been troubled. He recognized that Nassau Corp had a valuable trade secret for the production of a dramatically new type of Christmas tree lighting wire (277). He recognized that the valuation of such an asset was "delicate and sophisticated" (295). Indeed, this trade secret had a potential of making millions in profits and did make more than $2,000,000. Yet Judge Raum reached the result, shocking to any business man, that this infinitely valuable asset was not worth anything because it was not listed on the books at any figure. But Judge Raum completely overlooked the fact that under proper accounting practices there could be no figure on the books for this trade secret for there had been no amounts posted for research and development. But the trade secret and its earnings potential were nevertheless there.

Judge Raum also erred in giving weight to the fact that Nassau Corp did not apply for a patent on its trade secret (297). But it is the practice of many business men not to apply for patents for trade secrets. To do so, is often the best way to give away a trade secret. Nassau Corp by not

applying for a patent for its trade secret was at least able to have the exclusive use of it for a time.

Fair market value is what an unrelated willing buyer will pay to an unrelated willing seller. There are so many holdings to this effect that it can almost be called hornbook law. A statement by the Tenth Circuit in a recent case will suffice, *United States* v. *43,131.44 Acres of Land*, 483 F. 2d 569, 572 (10th Cir. 1973), and cases cited:

> "Fair market value of property is what an owner willing but not compelled to sell will take and what a buyer willing but not compelled to buy will give for such property."

Wilson Corp, which was not an exempt organization, was a willing buyer for a purchase price up to \$3,500,000. The Cathedral, which was an exempt corporation, was also a willing buyer for a purchase price up to \$3,500,000.

Parenthetically, one can observe that Wilson Corp, by its contract to purchase the stock of Nassau Corp, obligated itself to pay 75% of pre-tax profits for the first five years and 75% of after-tax profits for the second five years (166; Ex. 4-D). From this provision one can infer that Wilson Corp had a net operating loss carry over that, in its opinion, would shelter at least the first five years of income. However that may be, Wilson Corp, which was not an exempt organization, and the Cathedral which was, were each willing to buy the stock of Nassau Corp for a purchase price up to \$3,500,000. It is submitted that the taxpayers met their burden of proof and established that the fair market value of the stock of Nassau Corp in 1967 was \$3,500,000.

If the Commissioner wished to challenge the figure of $3,500,000 as the fair market value of the stock of Nassau Corp he had the burden of going forward. If he wished to challenge the validity of the sale itself he had the burden of proof. *McSpadden* v. *Commissioner,* 50 T.C. 478 (1968); *Wilson* v. *Commissioner,* 25 T.C. 1058 (1956); *Sheldon Tauber* v. *Commissioner,* 24 T.C. 179 (1955). He did nothing. He introduced not a scintilla of evidence to challenge the validity of the sale in the instant case or the fairness of the sale prise. All he did was to sit on his haunches—except for calling the Rev. Humbard, and the Rev. Humbard did not help him. On the contrary, he solidified the taxpayers' case.

He told about his work and that of the Cathedral. The Cathedral was and is a duly constituted religious corporation located in Ohio with a worldwide missionary program. Rev. Humbard pastors the church with the help of eleven associate ministers. The Cathedral has over 5,000 seats on one floor as well as a Sunday school, youth groups and a worldwide television program on more than 350 television stations.

Rev. Humbard and the Cathedral's board of trustees carefully considered purchase of Nassau Corp stock, finally purchased it for the same price, $3,500,000, that a non-exempt business corporation, Wilson Corp, had agreed to pay. There is not the slightest evidence to question the validity of the instant sale or the fairness of the sale price. In fact, the sale price could have been several times higher and still been fair.

ARGUMENT

POINT I

The transaction between the shareholders of Nassau Corp and the Cathedral was a *bona fide* sale for a fair price that falls squarely within *Commissioner* v. *Clay Brown*, 380 U.S. 563 (1965) and *Berenson* v. *Commissioner*, 507 F. 2d 262 (2d Cir. 1974).

All the facts show that the transaction between the shareholders of Nassau Corp and the Cathedral was a *bona fide* sale. Even the Commissioner acknowledged it as such. Moreover, all the facts show that the sale was for a fair price.

The Cathedral and its minister and pastor, the Rev. Humbard, are worldwide figures. The Cathedral is a financially responsible entity which was in existence long before the instant transaction took place and will continue to be in business long after. It was not created for the purpose of acquiring the stock of Nassau Corp.

The Commissioner's course in this case is much the same as the one he followed unsuccessfully in *United States* v. *Clay Brown*, 380 U.S. 563 (1965). In the Supreme Court the Commissioner claimed that since the charity assumed no independent liability for the purchase price, there was no sale. The Supreme Court responded:

> "To say that there is no sale because there is no risk-shifting and that there is no risk-shifting because the price to be paid is payable only from the income pro-

duced by the business sold, is very little different from saying that because business earnings are usually taxable as ordinary income, they are subject to the same tax when paid over as the purchase price of property. This argument has rationality but it places an unwarranted construction on the term 'sale', is contrary to the policy of the capital gains provisions of the Internal Revenue Code, and has no support in the cases. We reject it." At 570.

Justice Harlan in his concurring opinion added:

"Obviously the Institute traded on its tax exemption. The Government would deny that there was an exchange essentially on the theory that the Institute did not put anything at risk; since its exemption is unlimited, like the magic purse that always contains another penny, the Institute gave up nothing by trading on it.

"One may observe preliminarily that the Government's remedy for the so-called 'bootstrap' sale—defining sale or exchange so as to require the shifting of some business risks—would accomplish little by way of closing off such sales in the future. It would be neither difficult nor burdensome for future users of the bootstrap technique to arrange for some shift of risks. If such sales are considered a serious abuse, ineffective judicial correctives will only postpone the day when Congress is moved to deal with the problem comprehensively. Furthermore, one may ask why, if the Government does not like the tax consequences of such sales, the proper course is not to attack the exemption rather than to deny the existence of a 'real' sale or exchange." At 580.

The Commissioner tried to get the law changed legislatively but the Congress did not respond favorably until 196[illegible] Thus we find in the *President's 1963 Tax Message:*

> "Pursuant to the President's recommendation that changes be effected in the definitional aspect of capital gains taxation, it is proposed that payments on the sale of a capital asset (or payments so treated under present law) which are deferred over more than 5 years and are contingent on future income be treated as ordinary income."

Hearings before the House Committee on Ways and Means, 88th Cong., 1st Sess., Feb. 6, 7, 8 and 18, 1963, Pt. 1 (rev.), on the President's 1963 Tax Message, p. 154.

With reference to the Commissioner's 1963 attempt, the Court in *Clay Brown* wrote:

> "There is another reason for us not to disturb the ruling of the Tax Court and the Court of Appeals. In 1963, the Treasury Department, in the course of hearings before the Congress, noted the availability of capital gains treatment on the sale of capital assets even though the seller retained an interest in the income produced by the assets. The Department proposed a change in the law which would have taxed as ordinary income the payments on the sale of a capital asset which were deferred over more than five years and were contingent on future income. Payments, though contingent on income, required to be made within five years would not have lost capital gains status nor would payments not contingent on income even though accompanied by payments which were. Hearings before the House Committee on Ways and Means, 88th Cong., 1st Sess., Feb. 6, 7, 8 and 18, 1963, Pt. 1 (rev.), on the President's 1963 Tax Message, pp. 154-156.

"Congress did not adopt the suggested change but it is significant for our purposes that the proposed amendment did not deny the fact or occurrence of a sale but would have taxed as ordinary income those income-contingent payments deferred for more than five years. If a purchaser could pay the purchase price out of earnings within five years, the seller would have capital gain rather than ordinary income. The approach was consistent with allowing appreciated values to be treated as capital gain but with appropriate safeguards against reserving additional rights to future income. In comparison, the Commissioner's position here is a clear case of 'overkill' if aimed at preventing the involvement of tax-exempt entities in the purchase and operation of business enterprises. There are more precise approaches to this problem as well as to the question of the possibly excessive price paid by the charity or foundation. And if the Commissioner's approach is intended as a limitation upon the tax treatment of sales generally, it represents a considerable invasion of current capital gains policy, a matter which we think is the business of Congress, not ours.

"The problems involved in the purchase of a going business by a tax-exempt organization have been considered and dealt with by the Congress. Likewise, it has given its attention to various kinds of transactions involving the payment of the agreed purchase price for property from the future earnings of the property itself. In both situations it has responded, if at all, with precise provisions of narrow application. We consequently deem it wise to 'leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications.' *American Automobile Assn.* v. *United States,* 367 U.S. 687, 697." At 578-79.

In 1969 the Commissioner was more successful in obtaining new legislation. But the instant case involved the year 1967.

One will further note that in all of the Treasury Department position papers from 1963 to 1969 for new tax legislation it never challenged the validity of such a sale as that involved in the instant case. Rather, it sought in one way or another to have earnings taxed as ordinary income rather than as capital gains.

The Treasury Department in its study of 428 pages in 1969 for the House Ways and Means Committee began its treatment of sales such as the one in the instant case with these paragraphs:

> "H. R. 12663 and H. R. 12664 were introduced in the 90th Congress. They are designated to deal with the problems raised when tax exempt organizations borrow money for purposes unrelated to their functions. These problems were emphasized by the 1965 decision of the Supreme Court in *Commissioner* v. *Clay B. Brown,* 380 U.S. 563. In the *Clay Brown* case, the Supreme Court approved capital gains treatment for persons who sold a sawmill and lumber business to a tax-exempt organization in an arrangement elaborately structured both to avoid payment of Federal income tax upon the earnings of the business and to immunize the exempt organization from any liability or risk of loss. By means of the arrangement, the exempt organization undertook to acquire ownership of the business —valued at $1,300,000—entirely without investment of its own funds.
>
> "The availability of the tax exemption for uses in transactions following this pattern creates several se-

rious problems. First, when the purchase price of a business or other income-producing property is to be financed from the future earnings of the property, tax-exempt organizations are uniquely suited to pay a considerably higher price than other purchasers can afford; their exemption makes it possible for them, in effect, to pay to the former owners of the business the money which a taxable purchaser would have to pay to the Government in taxes. This advantage of exempt organizations creates a strong incentive for the sale of businesses to them. Secondly, the price inflation characteristic of transactions of this type diverts to the personal advantage of private parties a substantial measure of the benefit which Congress intended tax exemption to produce for the organizations on which it conferred the exemption. Dealing with a closely related problem some years ago, both the House Ways and Means Committee and the Senate Finance Committee referred to this result as a 'sale of the exemption.' "

Hearings before the House Committee on Ways and Means, 91st Cong., 1st Sess., Apr. 22, 1969, Pt. 14, pp. 5050, 5358-59. However, nowhere did the Treasury challenge the validity of sales to exempt organizations.

The legislative solution to *Clay Brown* was to deprive tax-exempt organizations of the commercial advantage flowing from their tax-exempt status to the extent they acquire businesses on credit (with the obligation typically limited to the assets acquired or earnings therefrom). The general nature of the new provisions was briefly described in the Senate Report (at pp. 63-64) as follows:

"Explanation of provision. Both the House bill and the committee amendments provide that all exempt

organizations' income from 'debt-financed' property, which is unrelated to their exempt function, is to be subject to tax in the proportion in which the property is financed by the debt. Thus, for example, if a business or investment property is acquired subject to an 80 per cent mortgage, 80 per cent of the income and 80 per cent of the deductions are to be taken into account for tax purposes. As the mortgage is paid off, the percentage taken into account diminishes."

The significant lesson to be learned from the congressional action taken as a result of *Clay Brown* and its impact on the decisions now under review herein, is that Congress did not deprive the seller of its right to receive capital gain treatment of the proceeds of the sale of an unrelated business to a tax-exempt organization. Instead, it deprived the tax-exempt entity of some of its tax exemption where the acquisition was debt-financed. There can be no doubt that this amendment to the Internal Revenue Code was perceived and intended as the proper response to the *Clay Brown* problem. Indeed it was referred to as the "*Clay Brown* provision" (Senate Report, pp. 62-63; Senate Hearings, p. 37).

The principal spokesman for the Treasury at the 1969 hearings was the Honorable Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy. In his testimony before the Ways and Means Committee (at p. 5491), Mr. Cohen referred to the Treasury recommendation as follows:

"We also recommend extending the provisions for taxation of unrelated business income to churches and other exempt organizations not now subject to these provisions. We recommend enacting legislation to overcome the effect of the Supreme Court decision in

the *Clay Brown* case, a bill which has previously been introduced and is pending before the committee."

This was amplified in his written statement (at p. 5509):

"8. Enact pending legislation to overcome the effect of the Supreme Court decision in the *Clay Brown* case to prevent a charitable organization from borrowing to purchase investment assets. The effect of such borrowing is often to pass the benefit of the tax exemption on to the seller, a non-exempt party, in the form of an artificially high price. There is no warrant in any event for a tax-exempt organization borrowing money to purchase income producing assets unrelated to its charitable function."

In the hearings before the Senate Finance Committee (at page 567) Mr. Cohen presented a statement which explained the proposed amendment as one which "prevents a tax-exempt organization from extending its tax shelter to a non-exempt seller through inflation of the price." It is clear that the legislation ultimately adopted by the Congress showed an election to solve *Clay Brown* by acting upon the tax exemption rather than disturbing the capital gain treatment which *Clay Brown* mandated. The Second Circuit so held in *Berenson* v. *Commissioner*, 507 F. 2d 262, 267 (2d Cir. 1974), when it wrote:

"To recount the Commissioner's victory in Congress, the Tax Reform Act of 1969 stripped transactions, such as that recognized to be a 'sale' in *Clay Brown*, of their tax avoidance potential by ensuring that the income from the business in the hands of the exempt organization was taxable as unrelated business income. Section 511 (a) (2) (A) was amended to sub-

ject churches and related organizations to the tax imposed by §511 (a) (1) upon 'unrelated business taxable income'; §514 was also revamped to ensure that rental income from all leases of business assets acquired through debt financing would be included within the exempt organizations' 'unrelated business taxable income.' No effort was made to alter the §1222 (3) capital gains provision at issue both here and in *Clay Brown*. Consequently, congressional disapproval of the Supreme Court's resolution of the 'sale' issue in *Clay Brown* cannot be inferred."

In *Berenson* the Second Circuit added to *Clay Brown* the requirement that the purchase price paid by an exempt purchaser must not exceed the purchase price that a nonexempt purchaser would have paid, saying

> "In sum, we conclude that the portion of the purchase price that is in excess of the price a nonexempt purchaser would have paid under identical terms is not part of the proceeds of a §1222 (3) 'sale' and is, therefore, taxable as ordinary income to the recipients." At 269.

Neither the taxpayer nor the Commissioner thought in these terms. The only direct testimony on fair market value was that of Aaron Kraut. He testified that he projected earnings over a ten-year period of at least $10-million and regarded this projection as a conservative one. In his figure of earnings of over $1-million a year had been for past rather than projected earnings, a fair market price for the stock of Nassau Corp would have been $10-million or more. Under the circumstances the figure of $3,500,000 can surely be taken as the fair market value of the stock of Nassau Corp in 1967. The record supports this figure.

The Commissioner introduced no evidence at all on fair market value, not even a scintilla. Revenue Agent Meyer Shapiro, who had been an Internal Revenue agent for more than 25 years (34), treated the transaction between the Cathedral and the shareholders of Nassau Corp as a valid sale and valued the stock at $500,000 (39; Ex. 7, Sched. 4-A2; Ex. 8, Sched. 4-A2). In Schedule 4-A2 of Exhibit 7, Mr. Shapiro wrote:

	1966	*1967*	*Total*
. . . .	. . .	. . .	. . .
Deemed Sale Price of Capital Asset	69,331.25	180,668.75	250,000.00
Basis of Cost	100.		100.
Capital gain realized at 100%	69,231.25	180,668.75	249,900.00

And in Schedule 4-A2 of Exhibit 8:

	1966	*1967*	*Total*
. . . .	. . .	. . .	. . .
Deemed Proceeds of Sale of Capital Asset of Each s/h	69,331.25	180,668.75	250,000.00
Cost Basis allowed	100.		100.
Capital gain realized —100%	69,231.25	180,668.75	249,900.00

The Commissioner himself treated the transaction between the Cathedral and the shareholders of Nassau Corp as a valid sale of stock, for in his statutory notice he assigned to the stock a value of $168,445.60 (31). This was apparently some multiple of earnings of Nassau Corp's development year, but a development year is not represent-

ative. At the trial the Commissioner introduced not one jot or tittle of evidence as to fair market value. It would accordingly seem that the figure of the taxpayers of $3½-million, from Mr. Kraut's testimony, and supported by the record, should be accepted. The taxpayers in the instant case should accordingly be granted the *Clay Brown-Berenson* capital gain treatment to which they are entitled.

POINT II

The Commissioner is foreclosed from challenging the validity of the sale.

The Commissioner in his statutory notices treated the transaction in the instant case as a sale of capital assets and allocated $168,445.60 of the sales price to capital gain (31). This figure was apparently some multiple of an unrepresentative development year's earnings.

Subsequently, both during the trial and after Judge Raum's opinion, the Commissioner sought to get away from his statutory notices by motions to amend his answers, and in his amended answers to claim that the sale was not *bona fide* and that the entire purchase price should be treated as ordinary income. Judge Raum summarily denied these motions (2, 7). The Commissioner did not appeal from Judge Raum's decisions.

Judge Raum was right in denying the Commissioner's motions. Since the Commissioner in his amended answers sought to depart from the grounds in his statutory notices he had the burden of proof and he did nothing to sustain this burden. *McSpadden* v. *Commissioner*, 50 T.C. 478

(1968); *Wilson* v. *Commissioner,* 25 T.C. 1058 (1956); *Sheldon Tauber* v. *Commissioner,* 24 T.C. 179 (1955). The Commissioner may not now challenge the validity of the sale. The only point left for decision is how much of the sales price in excess of $168,445.60 should be treated as capital gain.

POINT III

In no event should the purchase price to be paid by a tax-exempt purchaser be reduced by more than the amount that a nonexempt purchaser would have paid.

Berenson limited *Clay Brown* to the extent that an exempt purchaser may have paid an amount "in excess" of the price a nonexempt purchaser would have paid. Judge Raum also struggled with the question of excess. Unfortunately he did not have before him the guidelines of *Berenson.* In addition, the taxpayers suggest that Judge Raum's error in accepting so low a figure as that of the Commissioner, namely, $168,445.60, was the result of his having failed properly to evaluate the fair market value of Nassau's principal asset.

We cannot give a better description of that asset and its value than appears in Judge Raum's own findings of fact. Had the Messers. Kraut accrued substantial salaries, and capitalized as research and development expenditures their labor during the development period, the asset would not have been more valuable, but it would have appeared at a substantial figure in the accountant's balance sheet presentation of the company's "statement of Net Worth".

Indeed, it is a common and oft-times required accounting practice for public corporations. The illusion that an asset's fair market value is its appearance in the "book value" balance sheet presentation is deceptively strong, as the many note holders of the Pennsylvania Railroad, now in bankruptcy, will surely attest. However, it is equally certain that the fair value of an asset is its ability to produce further income.

If the instant case involved a minimally capitalized mineral tract on which there was subsequently discovered a valuable deposit, Judge Raum would have had no difficulty with a large difference between book value and sales price. Although by hindsight, the taxpayers might have better structured these transactions at their inception, in view of the subsequently decided *Berenson*, it must be remembered that they were not preparing for a tax case, but a business transaction involving the sale of Nassau Corp on the most advantageous terms possible. This, of course, included limiting the liability to be assumed by the purchaser as much as possible, particularly in view of the fact that the purchaser was not able to take title in corporate form in order to limit its risks. Regardless, however, as to why Judge Raum accepted as he did the Commissioner's arbitrary and minimal value for Nassau Corp it is clearly at odds with *Berenson* and therefore must be reversed.

Since under the *Berenson* doctrine the most that could be allocated as excess is the amount by which that price exceeded what a nonexempt purchaser would have paid, in no event would the amount of excess have exceeded 48% in 1967. A business man of course might have other econo-

mic reasons in purchasing a business than a nonexempt charity, as for example, vertical integration into his existing operation, or a net operating loss carry over. Under such circumstances it is possible that he would pay a price as high as or even in excess of that which a nonexempt charity might pay. But in no event would his purchase price be less than the amount of the corporate tax in effect at the time of his purchase.

In 1967, the year in question, the corporate tax rate was 48% on profits in excess of $25,000. In no event should the price of $3½-million that the Cathedral agreed to pay be reduced by more than 48%, the most that a nonexempt purchaser would have had to pay in taxes. In no event should the $3½-million be reduced to less than $1,820,000, which is 52% of the $3½-million purchase price that the Cathedral agreed to pay. The Commissioner's arbitrary and minimal figure of $168,445.60, which Judge Raum accepted, cannot be correct. The fair market value of the stock of Nassau Corp should be held to be $3,500,000, the price that a nonexempt purchaser, Wilson Corp, and an exempt purchaser, the Cathedral, agreed to pay.

Conclusion

The decisions below should be reversed and the deficiencies annulled.

Respectfully submitted,

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Affidavit of Service by Mail

In re:
Aaron Kraut and Iris Kraut
Harry Kraut and Marian Kraut v. Commissioner of Internal Revenue

State of New York
County of New York, ss.:

Harry Minott,

being duly sworn, deposes and says, that he is over 18 years of age. That on AUG 4 1975, 197....., he served 3 copies of the within Brief in the above named matter on the following counsel by enclosing said three copies in a securely sealed postpaid wrapper addressed as follows:

Gilbert E. Andrews
Appellate Section - Tax Division
Dept. of Justice
Washington, D.C. 20530

~~and depositing same in the official depository under the exclusive care and custody of the United States Post Office Department within the City of New York.~~

and depositing same at the Post Office located at Howard and Lafayette Streets, New York ~~N. Y.~~ 10013.

Harry Minott

Sworn to before ~~me this~~ 4th day of Aug 1975

Jack A. Messina
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